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Students' Department

H. P. Baumann

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H. P. Baumann, *Editor*

AMERICAN INSTITUTE EXAMINATIONS

[Note.—The fact that these answers appear in The Journal of Accountancy should not cause the reader to assume that they are the official answers of the board of examiners. They represent merely the opinions of the editor of the *Students' Department.*]

Examination in Auditing

May 15, 1930, 9 A. M. to 12:30 P. M.

Answer all the following questions:

No. 1 (10 points):
State the principal objects for which auditors' working papers are made and preserved.

Answer:

Auditor's working papers are prepared (1) to obtain and collect in usable form such data as are necessary to enable the auditor to prepare a report of the engagement; (2) to obtain a written record of work done to guide the auditor, and to serve as evidence of facts and statements presented in the report.

Auditor's working papers are preserved (1) to be used to furnish information which may be requested regarding the engagement or the report; (2) to assist the auditor in future engagements by obviating the necessity for investigation of certain transactions preceding such future engagements.

No. 2 (10 points):
Having received letters from several local customers questioning statements of account rendered them, your client engages you to make a detailed audit of the branch store from which the statements were sent. You direct a senior to make the audit after informing him of the circumstances. He finds in the course of a week many discrepancies for which the local cashier, who also keeps the books, offers vague and unsatisfactory explanations. At the close of a day the senior "as usual" (he says) puts all his working papers in his brief-case, which he locks and places in the store safe. The next morning he finds the office in confusion, the safe looted, and his brief-case gone—likewise the cashier. Several pages have been torn out of the cashbook, and the customers' ledger has disappeared. All this is reported to you and you take personal charge.

(a) Will you complete or retire from the audit?
(b) What fees, if any, will you charge your client?

Answer:

(a) The status of affairs should be reported to the client immediately with a request that he meet with the auditor at the branch for a discussion of the situation and of the course to pursue. At the meeting, the auditor should bring the following to the attention of the client:

(1) That the cashier's actions clearly indicate irregularities chargeable to him;

(2) That the disappearance of the customers' ledger and certain cash-book sheets are a serious loss to the client, as he now has no record of the amounts due him from customers;

(3) That it is possible for the auditor, if he is engaged to do so, to build up relatively accurate accounts owing from customers by requesting confirmations of accounts from all known customers, using as his guide such records of billings and remittances as may be available and the files of correspondence with customers.

(b) The senior accountant used reasonable care when he locked the working papers in his brief case which he placed in the client's safe. The client should be charged at the regular per diem rate for senior accountants for each day of time spent by the senior on the engagement.

No. 3 (10 points):

What special facts should be ascertained and how may they be verified in a detailed audit of accounts of any one of the following:

(a) Automobile dealers
(b) Stockbrokers
(c) Farmers

Answer:

(a) *Automobile Dealers.*

I. Verification and valuation of new and used car inventories. As soon as possible after beginning of the engagement, the auditor should make an actual inspection of all cars in the salesroom, warehouses, freight depots, service stations, etc., listing the make, type and factory number of each. Those not personally inspected should be confirmed by correspondence. The inventory of cars on hand at the balance-sheet date should then be determined by working back from the actual count by checking the entries in the car-record book against the purchases and sales made subsequent to the balance-sheet date. While new cars may generally be valued at cost, the auditor must take into consideration any factory price reduction on the current models made since the date of purchase or about to be made in the near future, and any obsolescence on any new cars of prior season's models which may have been carried over into the current season. Used cars, including cars used by the agency for demonstration purposes, should be valued at the estimated selling price, less the cost to put them in a salable condition, selling, and administrative expenses.

II. Instalment notes receivable. Instalment notes receivable representing time sales being financed by the dealer should be inspected and valued, and those out for collection, or discounted, should be confirmed by direct correspondence with the holders thereof.

III. Contingent liability on notes sold to finance companies. The auditor should request confirmations of all finance companies with which the dealer has been doing business to ascertain the amount of any contingent liability which may exist on account of instalment sales financed by such companies.

IV. Dealer's contract. The contract with the manufacturer or wholesale distributor should be examined to determine if he is adhering to the terms of the contract. The dealer may be required to deposit certain amounts for each car, or may be required to dispose of a certain number of cars per annum under penalty of losing his deposits or forfeiting his contract.

V. Salesmen's accounts. Salesmen's accounts should be reviewed in order to report their value. Advances to salesmen are frequent sources of loss to automobile dealers, and all accounts of doubtful value should be charged off.

VI. Sales of gasoline, etc. An examination of the records should be made to learn whether the total of the gasoline sales, both charge and cash, together with that used by the company, approximates the amount of gasoline purchased, less the inventory on hand. Such tests frequently disclose shortages.

(b) *Stock Brokers.*

Enumeration of special facts.

1. Security position.
    a. Securities on hand
        1. Collateral
        2. Safekeeping
    b. Securities in other locations
        1. At banks as collateral
        2. At banks for safekeeping
        3. At correspondent brokers
            a. Collateral
            b. Safekeeping
        4. In transit
        5. At transfer agents
2. Loans payable.
3. Customers accounts and position.
4. Due to and from brokers.

Manner of verification. At the close of business on the audit date the auditor should arrive at the client's office with his assistants after the securities have been locked up for the day. He should then take off the security position and customers' accounts from the records after all transactions have been recorded.

List of securities should be prepared, divided into the classifications shown above, to be used as counting sheets and verification guides. Letters requesting confirmations should be prepared and sent:

1. To the banks for loan balances, collateral, and securities held in safekeeping.
2. To correspondent brokers for balances and securities held.
3. To transfer agents for securities in transfer.
4. To others for transit items.
5. To brokers for amounts due to or from the brokers.

Copies of customers' margin records should be made, showing thereon debit and credit balances and security holdings, both collateral securities and safekeeping securities. Similar information should be obtained from the ledger accounts.

A copy of "security position" should be obtained for each security, showing the amount of each customer's holding and the location in total by classes of the securities: i.e., on hand, at banks, etc.

All of the above work should be accomplished the first evening.

In the morning the auditor must be present when the securities are brought out of the vault and must take complete charge thereof subject to supervision by the company. The count of securities on hand should be made, and a complete control of the securities should be maintained until the count is completed.

The auditor can now proceed to balance the position by checking the confirmations and count against the security position, and also by checking the margin and ledger records against each other and against the security position. To determine equities in the various ledger accounts, market values should be applied to all securities which the customer is long or short, and these values should be compared with the debit or credit money balances.

The accounts can then be classified as secured, partly secured, unsecured, etc.

The remainder of the audit should be handled in the same manner as other audits.

(c) *Farmers.*

I. Amount and valuation of inventories. Inventories should include quantities on hand of grain, livestock and all farm produce available for sale and on hand to be sold. These items may be verified from inventory sheets which the farmer should have prepared. They should be valued at market prices less the cost of delivery to the market and less any other costs necessary to effect the sale thereof.

Livestock on hand held for farm use, dairying or breeding, should also be inventoried at fair market value recognizing such factors as age of the animal, productivity, etc. This inventory and that taken at the beginning of the period should be checked by the auditor. Additions to this class of livestock will be capitalized by being included in the inventory.

II. Distribution of labor costs. Labor costs should be analyzed to get the proper allocation of cost applicable to:

1. Products raised for sale during the year. This cost should be charged as an expense because the products will be included in sales or closing inventory at realizable sales values.

2. Cost of handling and caring for breeding, dairy, and work animals. This labor cost should be segregated for information purposes; the total however should be charged as an expense.

3. Cost of planting and developing orchards, clearing the land or preparing the land for planting should be capitalized.

The information and allocations indicated above should be verified by examination of the payrolls, investigation of duties of the employees, and discussions with the owner or manager.

III. Value of produce consumed by livestock and people on the farm. Proper charges should be made for produce consumed on the farm. This should be allocated to the proper expense accounts and credited to the inventory. Investigation will no doubt enable the auditor to ascertain the amounts of grain, etc. consumed on the farm.

IV. Valuation of farm property, buildings, equipment, etc. Carelessness and a lack of appreciation of the value of keeping adequate records on the part of the farmer requires the auditor to be especially careful in determining the valuation of farm property, etc. Payrolls and other records of expenditures should be carefully examined to learn if all additions to the farm property, either purchased or constructed, have been properly capitalized. It is possible for the auditor to make a personal inspection of the fixed assets as a part of the verification. Depreciation of the fixed assets should also be computed.

No. 4 (10 points):

The church of X engages you to audit the books and certify the annual report of its treasurer. You find that the revenues consist of open plate collections, pew rents, envelope pledges, donations and interest from an endowment fund. The expenses are those ordinarily to be found in such cases. A good system of depositing all receipts in bank and making all disbursements by cheque is in force.

Assuming that you find the books correct as far as you can verify them, write a brief report of what you have done, closing with your certificate.

Answer:

Board of Trustees,
"X," New York.

Gentlemen:

Having completed our examination of the accounts of the church of "X" for the year ended December 31, 1929, we submit our report thereon, consisting of comments and the following exhibits:

Exhibit A—Statement of assets, liabilities and net worth, December 31, 1929.

Exhibit B—Statement of income and expenditures for the year ended December 31, 1929.

Schedule 1—Schedule of investments—endowment fund—December 31, 1929.

Our examination included the verification of the assets and liabilities as of December 31, 1929, and a review of the income and expenditures for the year ended that date. It is to be understood that we did not make a detailed check of all the transactions of the period, but rather a test check of transactions for April and December, 1929.

FINANCIAL CONDITION

The cash in bank was verified by reconciliation of the bank account and a confirmation from the depositary.

The investments in the endowment fund were verified by inspection. A list of the securities owned at December 31, 1929, showing the cost and the market value thereof at that date, is submitted in schedule 1; it will be noted that the market value at December 31, 1929, was $...... less than the cost of the securities owned. A reserve for this amount has been deducted from the cost of the securities shown in the balance-sheet.

The insurance policies in force were examined and it is our opinion that the church properties are adequately protected. The unexpired premiums as shown by the records were computed by us and found to be correct.

The land, church building, rectory, parish house and furnishings are carried at the appraised values set forth in the report of the "Z" appraisal company made as of December 31, 1929.

In so far as we were able to ascertain, all liabilities, including unpaid salaries, at December 31, 1929, were taken up on the books as of that date, and we were furnished with a certificate to that effect by the treasurer and the chairman of the finance committee.

INCOME AND EXPENDITURES

As shown in detail in exhibit B, the income for the year ended December 31, 1929, was $...... in excess of the expenditures for the same period.

In the course of our examination we found that the plate and special collections were counted by the treasurer and verified by a member of the vestry who initialed the entry of the amounts in the collection register. Pew rentals were entered in a pew-rental register. The receipts from plate and special collections and from pew rentals were checked against the cashbook by us, and all receipts recorded in the cashbook were traced to the bank.

From the schedule of securities we ascertained the amount of interest receivable from the investments in the endowment fund and verified the receipt of such interest. We also prepared and mailed statements to pew holders for any pew rents in arrears, with a request to confirm the amounts. Sixty-five (65%) per cent of the total was confirmed without exception.

The payments of salaries were verified and the amounts paid were to be found in agreement with those set by the board of trustees.

We also verified the payments for operating expenses, missions, benevolences, etc., which were supported by authorized vouchers.

CERTIFICATE

We have audited the accounts of the church of "X" for the year ended December 31, 1929, and

We hereby certify that, in our opinion, the accompanying statements correctly reflect the financial condition of the church of "X" at December 31, 1929, and the receipts and expenditures for the year ended that date.

Very truly yours,

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No. 5 (10 points):

In auditing the books of the A. B. Company you find an item of $1,000 debited to notes-payable account, but no canceled note is produced in support thereof, nor can you find a similar amount previously credited to this account. For good and sufficient reasons you do not desire to question the officers of the company until you have more information regarding the transaction.

(a) How would you proceed to obtain that information?

(b) What may you expect to learn?

Answer:

(a) The debit to the notes-payable account of $1,000 should be traced to the journal in which the transaction was recorded to determine, (1) the offsetting credit, and (2) the voucher or other papers supporting or authorizing the entry.

(b) If the entry represented a cash payment made, the auditor should inspect the canceled cheque to ascertain the date of issue, date of payment by the bank, the payee, and the endorsements. The signature on the cheque should be inspected to see if that was in order. The open accounts payable should be scanned to see if any account had been, or was being carried in the name of the payee, for the cheque may have been issued as a payment on an open account, or for some unrecorded liability.

It is also possible that a note was issued, entered in the notes-payable record but not entered in the notes-payable account, or that the cheque had been issued as a part payment on a note of a larger amount. A check of the entries to the interest-paid account may lead to important information.

If the "good and sufficient reasons" for not questioning the officers arose through some irregularity, suspected or otherwise, it is probable that one of the officers issued the company's note for $1,000 for his personal use, and that when the note was presented for payment, the company's cheque was issued, either through carelessness, or on instructions of the officer.

It is also possible that the debit entry was made in an attempt to conceal a shortage in the cash account or in an attempt to "bury" a loan to an officer, employee, or others.

If the entry arose through the general journal, it may be found that the offsetting credit was made to some receivable account in an attempt to improve the current position of the company.

No. 6 (10 points):

Entering upon an audit of the A. B. Company you are handed the general books of account and a trial balance thereof. You learn that the company owns all or a controlling amount of the stock of several subsidiaries, carried on the books at cost. The trial balance shows open accounts with each of the subsidiaries.

State what influence this knowledge would have upon you, and why, in respect to

(a) Proving the accuracy of the trial balance
(b) The steps you would take

Answer:

The investments in the wholly owned subsidiary companies should be verified by ascertaining the authority for the purchases of the stock of the companies by reference to the minute book and contracts covering the transactions, and by tracing the actual payments. The open accounts should be carefully analyzed as to the nature of the transactions which should be checked. The balances in these accounts should be confirmed by direct correspondence.

Even though the open accounts arise from sales to the subsidiaries, the balances should not be included with the accounts or notes receivable from customers. If the net current assets of a subsidiary are in excess of the amount which the company owes to the controlling company for purchases, the balance due may be shown in the balance-sheet of the controlling company as a current asset. If the open accounts represent advances of a permanent nature, the balances should be considered as additional investments and shown with the investments in the subsidiaries under the caption "Investments."

Unless the books of the subsidiary companies are audited, the investments in those companies should be stated at cost, and the certificate qualified accordingly. The fact that these investments are in wholly-owned companies, should be noted on the balance-sheet.

The auditor should make every effort to convince the officers of the A. B. Company of the desirability of having the books of the subsidiaries audited so that a consolidated balance-sheet can be prepared. In lieu of investment accounts in and open accounts with wholly-owned subsidiaries, assets and liabilities of like kind of all the companies would be consolidated so as more clearly to reflect the financial condition of the companies as a whole.

No. 7 (10 points):
State three methods, with your arguments for and against each one, of showing as an investment the premiums paid by a corporation on a policy in its favor on the life of its president.

Answer:

Three methods for showing as an investment the premiums paid by a corporation on a policy in its favor on the life of its president may be stated as follows:

1. The capitalization of the net premiums (i.e., premiums, less any dividends) paid.
2. The capitalization of the net premiums paid with a reserve accumulated by charges to profit-and-loss.
3. The capitalization of cash surrender value of the policies only.

Insurance is generally carried on the life of the principal officer of a corporation to aid the company to meet any material emergency arising because of the death of the officer. Even though he may continue active beyond his life expectancy, and the policy be continued in force, the amount of the insurance received at the time of his death will exceed the amount of the premiums paid. Because the amount ultimately received will be in excess of the amount of the premiums paid, it is contended that the asset is built up as the premiums are paid, and, therefore, the premiums should be charged to an asset account. However, it can not be known that the policy will be kept in force until the death of the officer. If canceled before that time, the excess of the premiums paid and capitalized over any cash surrender value will have to be written off to surplus.

As against capitalizing the premiums, there are some who contend that the premiums should be written off currently, as paid. This method open to criticism in that a secret reserve is being created, inasmuch as the balance-sheet does not disclose the fact that the life of the principal officer is insured in favor of the company. This objection is met by the advocates of the second method enumerated above. The method of carrying a reserve equal to the amount of the premiums capitalized is predicated upon the theory that the insurance is carried against a future loss, and that it is, therefore, necessary to create a reserve out of current profits against which the loss may be charged.

The third method of capitalizing only the cash-surrender value of the policies is a compromise, in that, after the second or third year, the premium is divided; a part being charged to expense and a part to an asset account. This method is more generally followed, because the amount carried as an asset may be converted into cash upon the surrender of the policies. The objection raised against this method is that the spread between the face value of the policies and the cash-surrender value is reduced each year, with a corresponding reduction in the protection afforded by the insurance.

In no case should the premiums capitalized or the cash surrender values be shown as a current asset.

No. 8 (10 points):
In auditing the books of Roe & Co. you find among the notes receivable one endorsed by John Doe, which is six months overdue, the maker having refused to pay it. You learn that Roe & Co. have neglected to notify John Doe of the default.

At the same time you happen to be auditing the books of John Doe, have already learned of this endorsement and propose to show it in a footnote on his balance-sheet as a contingent liability, with his knowledge and consent, though he "thinks" it has been paid.

Bearing in mind that, under the laws of the state in which this transaction occurs, John Doe is now discharged as endorser, how will you handle this matter in order to show it correctly on the respective balance-sheets?

Answer:

In the course of auditing the books of Roe & Co., a "request for confirmation" should be sent to John Doe, asking him to indicate his liability, if any, to Roe & Co., for the discounted note endorsed by him, which was still unpaid. The manner in which this matter would be handled in the respective balance-sheets would depend upon the answer received from John Doe.

If Doe replied that he was not obligated in the matter, under the laws of the state, the amount of the note, being uncollectible, should be written off, and the net worth reduced correspondingly in the balance-sheet of Roe & Co. On the balance-sheet of John Doe, the matter could be ignored entirely.

If Doe replied that he recognized his liability and was willing to pay the note when convinced that he had not already done so, the amount of the note should be shown on the balance-sheet of Roe & Co., as "notes receivable—past due," and included with the current assets. On the balance-sheet of John Doe, the amount of the note should be shown as "notes payable" and included with the current liabilities. The net worth of John Doe should be reduced by the amount of the liability thus set up.

The foregoing answer is based upon the assumption that the maker of the note was not financially responsible. If, however, the maker was financially responsible, the amount of the note should be transferred to accounts receivable and its collectibility considered by the auditor in setting up a reserve for doubtful accounts. Roe & Co. should press the maker for payment of the amount due, for their own protection in case Doe refused to waive his discharge under the laws of the state, and to reimburse Doe in case he paid the note as endorser.

No. 9 (10 points):

State in detail the proper methods of verifying the securities owned by a "fixed investment" company.

Answer:

A schedule should be prepared from the securities ledgers just prior to the date of the actual count and inspection of the securities, showing:

Dates of purchases.
Description of the securities, including the certificate or bond numbers.
Number of shares of stock or the par of the bonds owned.
Par value of stock, if any.
Where the securities are deposited, if not on hand.
Cost and market price of the securities.
Interest and dividends received.
If the securities are posted as collateral, with whom, and for what purpose.

The securities on hand should be examined by the auditor in person (a representative of the trust should be present) and checked against the schedule previously prepared—preferably at the close of business on the balance-sheet date. In any event, complete control must be maintained until all have been verified to prevent substitution. Securities out for transfer, delivery, safekeeping or collateral should be verified by direct communication with the transfer agents, depositaries, etc. The schedule of securities should be checked against the investment account or accounts in the general ledger to ascertain that the balances are in agreement.

In his examination the auditor should determine (1) that the bond coupons which are due subsequent to the date of his examination are intact, and (2) that the stock certificates are in the name of the company, or that they are endorsed or accompanied by powers of attorney if in the names of persons.

Purchase confirmations should be checked against the purchase records. The dates should be especially noted. Brokers' sales slips should be checked against the sales records; and here also, the dates should be carefully noted. Tests of the purchases and sales prices should be made against official price records, and of the extensions and other calculations. The footings and cross-footings of the sales and purchases records should be verified, and the postings to the investment accounts should be checked.

The dividends and interest record should be checked against the official list of dividends declared and interest paid to see that the total dividends and interest receivable to the company have been received and recorded.

The securities schedule should be checked with that prepared for the previous audit, and securities no longer owned should be traced through the cash-receipts book to the bank statement to account for their disposal. If the number of purchases and sales during the period were few, a detailed audit of such transactions is to be recommended.

In planning his work, the auditor should arrange for the audit of the cash accounts and other negotiable securities simultaneously with the audit of the security portfolio.

No. 10 (10 points):

A purchased bonds in 1910 for $100,000. Their fair market value March 1, 1913, was $112,000. He sold them in 1929 for $90,000. His only other income for 1929 was a salary of $45,000 and interest $5,000, with no deductions claimed. Disregarding any exemptions or credits to which he might be entitled, show the calculations you would make to ascertain the income-tax A will have to pay. (Surtax on $50,000 is $2,980; on $28,000, $720.)

Answer:

The authority for the following calculations is section 101 of the revenue act of 1928 from which the following is quoted:

> "(b) Tax in case of capital net loss.—In the case of any taxpayer, other than a corporation, who for any taxable year sustains a capital net loss (as hereinafter defined in this section), there shall be levied, collected, and paid, in lieu of all other taxes imposed by this title, a tax determined as follows: a partial tax shall first be computed upon the basis of the ordinary net income at the rates and in the manner as if this section had not been enacted, and the total tax shall be this amount minus 12½ per centum of the capital net loss; but in no case shall the tax of a taxpayer who has sustained a capital net loss be less than the tax computed without regard to the provisions of this section."

"(c) Definitions (for the purposes of this title):

(2) 'Capital loss' means a deductible loss resulting from the sale or exchange of capital assets.

(6) 'Capital net loss' means the excess of the sum of the capital losses plus the capital deductions over the total amount of the capital gain.

(7) 'Ordinary net income' means the net income, computed in accordance with the provisions of this title, after excluding all items of capital gain, capital loss, and capital deduction.

(8) 'Capital assets' means property held by the taxpayer for more than two years (whether or not connected with his trade or business), . . ."

The bonds which "A" purchased in 1910 and sold in 1929 must be considered as "capital assets" and the resulting loss, therefore, a capital loss. The basis for determining the gain or loss from the sale or other disposition of property acquired before March 1, 1913, shall be (1) the cost of such property, or (2) the fair market value of such property as of March 1, 1913, whichever is greater. (Section 113 (b) of the revenue act of 1928).

STATEMENT SHOWING COMPUTATION OF TAX

Ordinary net income:	
Salary	$ 45,000.00
Interest	5,000.00
Total ordinary net income	$ 50,000.00
Capital net loss:	
Fair market value of bonds as of March 1, 1913	$112,000.00
Selling price of bonds	90,000.00
Capital net loss	$ 22,000.00

Computation of Tax

$ 4,000.00 at ½ per cent	$ 20.00
4,000.00 at 2 per cent	80.00
42,000.00 at 4 per cent	1,680.00
Surtax on $50,000.00	2,980.00
Total tax	$ 4,760.00
12½ per cent of capital net loss ($22,000.00)	2,750.00
Balance of tax	$2,010.00

However, it is also necessary to compute the tax "without regard to the provisions" of section 101.

Ordinary net income	$ 50,000.00
Less capital net loss	22,000.00
Net income subject to normal and surtax	$ 28,000.00

Computation of Tax

\$ 4,000.00 at ½ per cent	\$ 20.00
4,000.00 at 2 per cent	80.00
20,000.00 at 4 per cent	800.00
Surtax on \$28,000.00	720.00
Total tax	\$ 1,620.00
"A" will be required to pay the larger amount, or	\$ 2,010.00

Illinois Accountancy Examination

This department has been requested to answer the following question set by the board of examiners in accountancy, University of Illinois, in the examination in auditing, May 15, 1930.

Question:

In connection with the audit of the "Y" Corporation, you find an account called "land and buildings," which has been charged with the following:

Date	*Particulars*	*Amount*
2/ 1/29	Attorneys' fees in connection with organization of the company	\$ 1,000.00
2/ 6/29	Cost of land and old building	112,400.00
2/28/29	Discount on sale of stock	15,000.00
2/28/29	Miscellaneous organization expenses	518.12
2/28/29	Cost of razing old building	2,546.00
3/17/29	Attorneys' fees and expenses in connection with the purchase of land and old building	2,000.00
3/31/29	Stock bonus given to promoters; 150 shares of preferred stock—par value \$100 each	15,000.00
3/31/29	Administrative and general expenses, February and March	6,318.13
4/15/29	Total cost of new building erected	96,318.63
4/15/29	Discount and expense on bonds	5,000.00
5/ 6/29	Real estate taxes	1,850.33
5/31/29	Administrative and general expenses, April and May	14,419.64
10/15/29	Interest on bond issue	3,250.00
	Total per books	\$275,620.85

You also find that:

(1) The "Y" Corporation was organized January 2, 1929.

(2) The bond issue was for the purpose of paying for the cost of the building, is dated 4/15/29, bears a 6½% interest, and is payable semi-annually.

(3) Real estate taxes of \$1,850.33 were deducted from the purchase price of \$112,400 and were credited to organization expenses at February 6, 1929.

(4) On February 28, 1929, the balance of \$518.12 in the organization expense account was charged to land and buildings.

(5) The normal operations of the business commenced July 1, 1929.

(6) Administrative and general expenses consisted of:

Officers' salaries	\$16,000.00
Factory superintendent's salary	3,000.00
Supplies, light, heat, etc.	1,737.77
Total	\$20,737.77

(7) Other than reviewing the plans, blue prints, etc., neither the officers nor the factory superintendent were connected with the construction of the new building.

In order that depreciation may be properly computed, you are to set up separate accounts for land and buildings, stating your reasons supporting the various kinds of items which you include in each account.

In case certain charges found in land and buildings are not, in your opinion, properly chargeable to either land or buildings, state what disposition you would make of them.

Answer:

"Y" Corporation

Land Account

Date	*Description*	*Amount*
Feb. 6, 1929	Cost of land and old building................ The contract price of the land and old building which is to be razed is a proper charge to land account.	$112,400.00
Feb. 28, 1929	Cost of razing old building.................. Inasmuch as it was necessary to raze the old building before the new building could be erected, and as it was not the intention of the corporation to use the old building; the cost of that structure and the cost of razing it is a proper charge to the land account. Some writers suggest that the cost of razing the old building should be charged to the cost of the new building. As the value of the new building is not increased by the expense of razing the old building, such a charge should not be made.	2,546.00
March 17, 1929	Attorneys' fees and expenses in the purchase of land and old building are additions to the cost of the land..............................	2,000.00
	Total..................................	$116,946.00

"Y" Corporation

Building Account

Date	*Description*	*Amount*
April 15, 1929	Total cost of new building erected.............	$96,318.63
July 1, 1929	Accrued interest on bonds for the period April 15, 1929 (date of issue), to June 30, 1929 (the normal operations of the business commenced July 1, 1929), may be charged as a part of the cost of the building which was financed by the issue of $100,000 of 6½% bonds...........	1,354.17

"Y" CORPORATION

Building Account (continued)

Date	*Description*	*Amount*
July 1, 1929	Amortization of bond discount for the period April 15, 1929, to June 30, 1929, should also be charged to the building cost for such amortization is, in effect, interest. While the nominal coupon rate of interest is 6½% per annum, the effective rate of interest is the coupon rate, plus that portion of the bond discount applicable to the period. The question fails to state the life of the bonds, but for the purpose of this answer, the life is considered to be 20 years. As the annual charge for bond discount amortization would be $250 ($5,000÷20), the charge for the 2½ months of the construction period would be..........................	52.08
	Total................................	$ 97,724.88

In view of the fact that the examiners did not state the life of the bonds over which the bond discount and expense could be amortized, it is believed that the candidate could not be criticized if he made no assumption as to the life of such bonds in order to determine the amount to be capitalized. However, as the interest accrued during the period April 15, 1929, to June 30, 1929, was capitalized in the above solution, it was considered necessary to make such an assumption, in order to capitalize the additional interest represented by the bond discount for the same period. It should also be noted that some writers would not consider the interest as a part of the cost of the building.

The other items appearing in the account called "land and buildings" should be treated as follows:

Date	*Particulars*	*Amount*
Feb. 1, 1929	Attorneys' fees in the organization of the company should be charged to organization expense................................	$ 1,000.00
Feb. 6, 1929	The real-estate taxes of $1,850.33 (note 3) were assumed by the vendor of the land and old building, and deducted from the cost of such land and old building by the "Y" Corporation. The amount should be charged to organization expense (which had been credited in error) and credited to accounts-payable account....	1,850.33
Feb. 28, 1929	Discount on sale of stock should be charged to an account called "discount on capital stock"—a deferred charge to be written off against surplus in the future...............	15,000.00
Feb. 28, 1929	Miscellaneous organization expense should be charged to organization-expense account.....	518.12

March 31, 1929	Stock bonus given to promoters should be charged to organization expense as it represents a part of the cost of organizing the corporation	15,000.00
March 31, 1929 and May 31, 1929	Administrative and general expenses for February, March, April and May. These expenses were not incurred in the acquisition of the land or the erection of the building so can not be properly charged to either of these accounts. However, if it were found that some part of the supplies, heat, light, etc., were used in the erection of the building, they may be charged to the building account. Otherwise, the total of the administrative and general expenses for the period should be charged to organization expense..	20,737.77
April 15, 1929	Bond discount and expense should be charged to the account of like name. That portion charged to building cost, $52.08, should be credited to the bond-discount account, which is a deferred charge to be written off over the life of the bonds...................	5,000.00
May 6, 1929	Real-estate taxes should be charged to the accounts payable set up in the second entry above..................................	1,850.33
Oct. 15, 1929	Interest on bond issue should be charged to the expense account "bond interest," which was credited with the $1,354.17 charged to building cost................................	3,250.00